The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: August 2006

A Comity of Errors

Much has been made of partisanship's corrosive effects on policy. However, this year's stampede to the exits for the summer recess also revealed the sharpening lines of division between Congressional chambers. In recent proceedings, there has been almost as much difficulty between the House and Senate as between Republicans and Democrats.

The conference committee, once a virtual given in the legislative process, has taken a beating this Congress. The breakdown began when the House and Senate took radically different positions on immigration reform. After both chambers passed their versions of the legislation, a virtual campaign began that often rose to the level of emotion typically reserved for the other party's candidate in November. House and Senate committees called hearings along the Mexican border and elsewhere across the country to lambaste the legislation approved by the other body. Although immigration reform has been ready to go to conference since April, conferees have not been named and will, as likely as not, never be appointed as one chamber uses the other to declare to their voters: "I'll save you from those other bums."

What began with immigration appears to have leaked into other business. Just before August recess, House and Senate Republican leaders bypassed the regular order to assemble the "trifecta" tax legislation of estate tax relief, minimum wage increases, and tax credit extenders, stepping on the feet of committee chairmen as they did so. Similarly, the GOP leadership plucked the pension overhaul bill from conference, made what changes seemed best to them, and moved the new bill to the House and Senate floors in a repudiation of the conference process instituted to protect the prerogatives of the two chambers of Congress. The House then passed its version of these controversial measures and adjourned, essentially telling the Senate that it was done with these issues and the Senate could pass them or let them die. In this case, the Senate adopted the pension bill and defeated the tax bill, killing the GOP's vision for estate tax relief for the third time this Congress.

These maneuvers may have effectively served to break legislative logjams but they display a certain level of contempt for the rules and the rights those rules are intended to protect. Bending the rules in this fashion does not appear to be generating goodwill, or a sincere desire to legislate, among Members of Congress. For example, rumors now circulate that some House leaders have lost interest in going to conference with the Senate on health information technology (IT) promotion. The House passed its own bill, and that is a sufficient accomplishment for campaign purposes, goes this reasoning, especially when a more unified Senate (which passed health IT unanimously) holds the stronger position in conference.

Partisanship certainly contributes to the slight record of accomplishment this Congress. Leaders have often opted for highly controversial proposals (such as on estate tax relief and Social Security reform) that jam the legislative gears without result rather than choosing consensus plans that win bipartisan approval and address real problems. The deterioration in comity between Congressional chambers may simply be a reflection of a frustrating session where emotions have run high on issues such as the Iraq War and related surveillance policy, leading to accusations about the other side's patriotism. For all that agitation, or because of it, there is a worrisome lack of bread and butter achievements to show voters come November.

Issues and Events

Pension Bill Survives Legislative Gambit to Become Law

The Pension bill passed through a peculiar variation of the usual legislative process that briefly made it a chit in a high stakes game of tax policy "chicken." The measure survived its brush with danger, however, when the Senate blinked and passed H.R. 4, the new pension package, without a single change. The President signed the bill into law on August 17.

Faced with summer adjournment's approach without a final deal on a pension bill that had been in conference for months, GOP leaders adopted a new strategy devised by Bill Thomas (R-CA, Bakersfield), Chairman of the Ways and Means Committee. In a bold power play to accomplish nearly every conservative tax policy goal in one fell swoop, Thomas and the leaders broke the pending tax bills into two main packages. The negotiations up to that point on the pension bill were embodied in a new bill, H.R. 4, despite the clear unhappiness of many conference participants and two Senate committee chairmen, Chuck Grassley (R-IO) of the Finance Committee and Mike Enzi (R-WY) of the Health, Education, Labor, and Pension (HELP) Committee. Another bill, H.R. 8, became a three-part "trifecta" measure offering something for all: estate tax relief favored by Republican conservatives, raising the minimum wage favored by Democrats and Republican moderates, and tax credit "extenders," favored by virtually all regardless of ideology. Under a procedural rule maximizing the power of the leaders and the majority, both measures were passed hours before the House went home.

By passing the legislation and adjourning, the House had told the Senate, "This is our offer; take it or leave it." As it had done a number of previous times, the Senate "left" H.R. 8, rejecting the legislation on procedural grounds as the minimum wage hike and extenders proved insufficient to overcome Democratic objections to the estate tax revisions. Once the more acrimonious business concluded, the Senate swiftly "took" the pension bill, H.R. 4, by passing it without amendment and clearing the measure for the President.

The new law contains Senate-passed language providing important revisions to IRC Section 415(n) dealing with the purchase of service credits, specifically permitting their purchase for periods for which there is no performance of service (e.g. airtime), and in order to qualify for an increased benefit (e.g. a higher tier/formula in the same plan). In addition, the language would clarify that (1) trustee-to-trustee transfers of 403(b) and 457 funds into a governmental defined benefit plan to purchase service credit does not need to be tested under the 415(n)limits on after-tax contributions to the plan; (2) once 403(b)/457 funds are transferred to a governmental defined benefit plan, they take on the distribution rules of such a plan; and (3) transfers need not be made solely between plans maintained by the same employer.

The newly passed law also makes the pension provisions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 permanent. This means that such important changes as the EGTRRA increases in the limits on contributions, benefits, and compensation would not expire in 2011. Other significant changes that would be protected from expiring include permitting elective deferrals to not be taken into account for purposes of deduction limits; the repeal of coordination requirements for deferred compensation plans; and the catch-up contributions for individuals age 50 and older, to name a few.

Important relief from the minimum distribution rules is also included, with directions to the Treasury Department to issue minimum distribution regulations permitting governmental plans to be able to operate on a good-faith basis.

In addition, the bill contains the Senate-passed version of the waiver of the 10% penalty for public safety employees participating in deferred retirement option plans (DROPs) and similar benefits who retire between ages 50 and 55. (The original House bill's specific statutory definition for a DROP that could be problematic for many plans was "dropped".)

Finally, the amendment allowing public safety officers who retire or become disabled to pay for health or long-term care insurance on a pre-tax basis was also included, but the annual cap was lowered from $5,000 to $3,000.

The one area in which public plans may not have fared as well deals with the application of ADEA to cash balance/hybrid plans. The bill permits a test for ADEA purposes where there is no violation of the ADEA if the accrued benefit of an older worker is greater or equal to that of a comparable younger worker. Plans would have to provide an interest credit no greater than a market rate of return and apply this rate to contributions and interest to contributory DB participants leaving their systems.

The process may have been among the uglier ones encountered in more than a decade, but the long road to EGTRRA permanency has finally led home.

Firms, Plans, Exchange Views on Funding Status, Trends; Congress to Investigate

The run up to Congressional adjournment for the summer saw the release of two noteworthy reports on the state of public plan funding. Deloitte & Touche released a study entitled "Paying for Tomorrow," which drew the attention of the plan community as yet another attack on public defined benefit plans. The consulting company's report pitches a public pension "crisis" brought on by the expansion of benefits during the strong markets of the 1990's. It estimates that public plans are now only 80% funded, a contrast to the recent estimate of 87% found by Wilshire Associates.

Deloitte stated "The unsustainable growth in pension funding requirements could easily crowd out opportunities for governments to invest in education, economic development, and health care." The firm recommended short-term solutions such as curtailing abuse in sick leave, especially for "costly 'public safety'" officers; reducing or eliminating special benefit formulas; and finding additional funding. For the longer term, Deloitte favored establishing minimum funding requirements, creating two-tier retirement arrangements where new hires can be shifted into cheaper DC plans, and restricting COLAs to the actual rate of inflation.

The substance and tone of the Deloitte report found its way into an August 8 *New York Times* story on public pension funding problems and corruption. Many in the public plan community found the Deloitte report and the *Times* story to be using the problems of a few systems to unfairly conclude that there is a nationwide public pension problem. The two main public pension groups, the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR), sent a letter to the editors that detailed their view of the numerous flaws in the press coverage in the *Times* story. The groups wrote:

> *The fact: public pensions collectively are financially sound, funded at nearly 90%.*
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> *It is patently false that public pensions have no "systems of checks and balance." There are stringent state and local laws and regulations, comprehensive oversight and governance, as well as regular reports, audits and actuarial valuations that provide safeguards - which often pre-date and exceed federal laws for private sector pensions.*
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> *Distorting the true financial condition of public pensions and mistakenly extrapolating a handful of issues onto the entire public pension community is unacceptable and only serves to further erode confidence in retirement security.*

Shortly after the *Times* story, Standard & Poors reported that average pension funding in the 20 largest cities has fallen from 99.8% to 84% in the last 5 years. The rating agency attributed the drop to a variety of factors on both sides of the ledger, including poor investment performance, increased life spans of participants, and recent benefit enhancements. Philadelphia, Boston, Chicago, and El Paso are said to have the biggest shortfalls while Milwaukee, San Francisco, New York City, and Detroit are above or just slightly below 100% funding. The report notes that a large contributing factor to the funding dip comes from the high exposure in equities for most funds and the steep drops in those assets in 2001 (16%) and 2002 (19%).

Most recently, the House Education and Workforce Committee rescheduled a field hearing entitled *"Examining the Retirement Security of State and Local Government Employees"* for August 30th. The hearing will be held in Springfield, Illinois, and will feature testimony from witnesses Joanna Webb-Gauvin of AFSCME (Springfield, IL), Illinois Retired Teachers Association Executive Director Jim Bachman, Professor of Economics University of Illinois, Fred Giertz, Deloitte Consulting LLP Lance Weiss, Illinois Budget Director John Filan, and Keith Brainard of NASRA.

Congress also ordered the Government Accountability Office (GAO) to study the funding status of public sector pension and health benefit systems during its recent consideration of private sector defined benefit plan funding. The GAO study offers another opportunity to clarify the record of public plans in protecting beneficiaries and taxpayers or the justification for Federal intervention.

Public plans should expect this war to continue for the foreseeable future. More than a few policy groups oppose the DB plan in principle, believing that individuals should be responsible for their own retirement and that others should not be burdened with financial ties to their fellow citizens. This ideology underlies the bias for a DC plan approach in other areas like Health Savings Accounts and Social Security privatization. Until and unless these experimental approaches to benefit delivery come up short in providing a meaningful benefit or are shown to be deficient, those who view retirement policy overwhelmingly through the lens of cost and exposure rather than in providing livable benefits will continue to attack the DB plan structure.

Health IT Supporters Wary but Optimistic

Passage of the House health information technology (IT) bill (H.R. 4157) brought near term hope to those seeking relief from escalating health costs. However, advocates caution those interested in seeing the bills become law that the conference process is not what it once was, and that political considerations may yet scuttle a deal on this measure.

Developing an interoperable health IT system seems to neither excessively reward nor punish any particular part of the health system. And yet some Capitol Hill sources suggest the bill may be in trouble and continue to advise caution even though the health IT bill - passed by a substantial margin in the House and unanimously by the Senate - would have been considered a "sure thing" in the past. But the prickliness of the chambers toward each other has become more intense in this Congress, largely fired by the immigration impasse that seems to have been allowed to fall back from legislative priority to electoral tool. With much of the political steam for moving the Health IT bill in the House coming from political concerns for certain members deemed at risk, the accomplishment of passing a House bill may be considered to have been enough.

The appointment of conferees to iron out differences between the two chambers' version of the measure when the House and Senate return from their August recess is therefore unfortunately uncertain. Meanwhile, the White House pressed forward with its own approach, ordering four Federal Departments to develop quality rating metrics to make available to participants in their health systems. The decision covers Medicare, TRICARE and other systems under the Department of Defense, the Federal Health Benefits Program, Indian health care programs, and the Veterans Administration's healthcare network. Because of deep State involvement, the order does not cover Medicaid or State CHIP programs. According to the Department of Health and Human Services, the executive order affects about one in four Americans with coverage. Some reformers believe that consumers will bring market pressures to bear and lower costs by promoting more aggressive competition and that solid information will allow them to choose the optimal health coverage for their needs. "The fact is, if you have excellent information about quality, about service and about price, people make good decisions," the President explained at the executive order signing ceremony on August 22.

Furthermore, the order also directs these Federal departments to begin upgrading their technology to support an interoperable system and electronic health records (EHR) wherever possible, building the capability as they acquire or upgrade their equipment. These departments will also promote the same kind of gradual improvements in capability outside of the government through contracts with providers, plans, and issuers. Agencies will begin the process by January 1, 2007. The order itself does not provide a substantive definition of "interoperable," which is still being developed at HHS.

California Congressional Delegation

Californian Pension Conferees Thomas, McKeon Secure EGTRRA Provisions

While sometimes in doubt during the long process, the Republican-controlled conference on pension overhaul featured two hard working Californian Members, Ways and Means Committee Chairman Bill Thomas (R-Bakersfield) and Education and the Workforce Committee Chairman Buck McKeon (R-Santa Clarita). The pension package pushed through Congress retained the EGTRRA provisions originally included in the House version in the final version delivered to, and ultimately approved by, the Senate. The Senate version of pension reform never included making the EGTRRA measures permanent and thus it is because of the House, and House leaders such as Thomas and McKeon, that the provisions carried into the new law.

Majority Leader John Boehner (R-OH) thanked Thomas in particular during floor consideration of the measure. "I want to thank my friend from California, Chairman Bill Thomas, whom I have worked on this proposal with for the last 5 years. We all know Bill is a sweet, lovable human being. This is his last year as chairman of the Ways and Means Committee. And I have got to tell you that all of us in the House, whether we agree with Bill or disagree with Bill every day, Bill is someone who works hard, puts his mind to it, and no one has worked harder in bringing this bill to the floor tonight than my colleague and friend from California, Mr. Thomas."

Miller Fights for Fairness in Cash Balance Conversions, Funding

Although somewhat supportive of many provisions in the pension overhaul bill, Congressman George Miller (D-Richmond) ultimately opposed the legislation and led the effort to recommit the bill for changes. Miller urged his colleagues to alter the bill to better protect older workers in cash balance conversions, who the AARP and others have suggested can be treated unfairly. He complained about the process, saying, "It is difficult to understand all of the things that have been done in this legislation, certainly for the Democratic Members of the House since we were not included in this conference committee. We were not invited into any of the sessions, nor was the information shared with us as it was developed during the conference committee because they chose to run it simply on a partisan basis among the House conferees."

Miller's motion to recommit urged the House to adopt the Senate-passed language on controversial airline pension plan funding and on older worker protections in cash balance conversions. In cash balance conversions, Miller warned that “Many workers will lose hundreds of dollars a month in expected retirement benefits. Many of these workers will be in excess of 50 years of age, and it is highly unlikely they will be able to recover the retirement benefits that they have been counting on for many years, that they signed a contract for in exchange for their labor with their employers. Today, the Congress is getting ready to tell them they are not going to make the employers live up to their agreements, and we are not going to even provide a transition to soften the economic blow when those agreements are changed.” Despite a valiant effort, the motion fell on a 189-222 vote.

Related National and Industry News

Execs Review Their Options

This month, prominent business executives approved a white paper that advocates scrapping new Financial Accounting Standards Board (FASB) rules on expensing stock options. FASB and the Securities and Exchange Commission (SEC) concluded the process of adopting new rules less than one month ago which included new measurements for valuing stock options awarded as part of compensation. FASB developed the valuation standards adopted by the SEC for use in its new executive compensation disclosure initiative.

After reviewing more than 20,000 comments, the SEC approved a rule circulated in January, 2006. It required plain-English disclosure of a bottom-line compensation figure for the most prominent employees (management and otherwise) of each public company and how the method of compensation selected furthers the goals for which the company seeks to create incentives. One of the most common practices is to compensate key managers in stock options so that their interests are aligned with the shareholders. Because options serve a key role in executive compensation, the SEC rule once again attempted to accurately capture the value of stock options as part of the push for more honest and accessible compensation disclosure.

Not so fast, a slumbering other side of the issue insists. A financial who's-who lent their *gravitas* to the study, appearing in California Berkeley’s Haas School of Management's *California Management Review*. Reports say that three Nobel Prize winners in economics (including Milton Friedman), two former CEOs of Big Four accounting firms, and two former US Treasury secretaries (including Paul O’Neill) support the paper, which asserts that the new FASB rules would cloud rather than clear the financial accounting waters. Venture capitalist Kip Hagopian wrote the piece and has been the lead man in presenting the group’s views to the public. Hagopian claims that options do not meet the FASB definitions for expenses because they do not involve the "consumption of cash." The paper thus argues that options are not normal expenses for a company because shareholders, not companies, bear any potential expense from dilution of equity if employees exercise their options. If stock options treatment changes under FASB, it would almost certainly change for SEC disclosure purposes.

Warren Buffet remains the luminary supporting the new option expensing rules, which he has supported in theory since 1992. "If options aren't a form of compensation, what are they? If compensation isn’t an expense, what is it?" he reasoned in his own past remarks on the subject.

The SEC is conducting an inquiry into stock option practices such as backdating. While a separate issue from valuation and reporting, the expansive SEC investigation strongly suggest that no movement on revisiting the FASB rule or otherwise lowering the disclosure standards seems likely in the near term, even with the impressive pedigree of those backing a change.